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Educating Bankers on Law, Ethics and Social Values: A Perspective from the US, the UK and Europe.

Abstract

The paper questions how global businesses can alter their attitudes to make them more ethical and transparent. It examines three causes of a financial catastrophe that are possibly linked to bankers' attitudes and mindsets: bankers' excessive greed that leads them to fall into ruinous temptations such as securitisation and short-termism, bankers' behavioural limitations such as overconfidence and over optimism and finally bankers' ignorance of financial products. The paper then considers an alternative model to confronting bankers' deficiencies that is more sustainable in the long run: the tool of education. When there is so much disapproval of companies for their lack of corporate social responsibility, education can help significantly. Its role is three-fold: First, it can alert future leaders of the positives of acting selflessly and for socially responsible goals. Second, it can teach them of what the law *actually* says: that they must promote the company's best interests – and not the shareholders' short-term interests – a matter frequently ignored within business practice. Finally, via education future leaders can learn a thing or two about the behavioural weaknesses often characterising people in high executive positions; they can also learn about the risks of showing poor judgment and unfamiliarity of a business' financial nuances and related risks. These 'educational measures' can help restore integrity back into banking whilst underlining the weight of ethics-based corporate cultures.

Keywords

Bankers, Short-termism, Securitisation, Behavioural Economics, Ignorance, Education, Ethics, Regulation, Market.

1. Introduction

Not many had foreseen that by the end of the global financial meltdown beginning in 2008 the economy would have been in such turmoil – a turmoil most observers believe to have been the cause of a blend of factors including the under-regulation of new financial products,¹ the laissez-faire attitude to investment banking and the environment of deregulation that dominated the western world at the time. Since then, plenty of academic and governmental studies investigating the crisis' triggers point to financial, economic and managerial factors.² Certainly the highly risky and unsound business models are largely to blame; models that resulted in illustrious failures such that of Northern Rock, formerly the UK's eighth largest bank and subsequently nationalised, and Fortis Bank, one of Belgium's largest banks that was eventually split into two parts as a result of severe liquidity problems.³ And while banks faced the prospect of failure, the world turned against bankers – the self-regarding decision-makers who appeared comfortable to gamble away their institutions' money, placing little emphasis on risk management or the long run. We saw bankers failing to pursue solid business plans or adopt risk management systems to measure, monitor and control risks. These were people driven by high profits from high-yielding loans and securities, and high-fee income from subprime loans.⁴

A decade has passed and there is still work to be done. Real improvement has been slow despite the vast amounts of new regulation coming through. Some of the newly introduced measures may even prove socially regressive, such as the increase of shareholder involvement with management through the UK Stewardship Code. Similar efforts have taken place in other markets in Europe, such as France and the Netherlands. But turning large investors into stewards is admirable in one sense and

¹ Such as different types of securitizations, subprime mortgages and credit default swaps.

² William C Handorf, 'Lessons from 2008 US bank failures' in Laurence E Mitchell and Arthur E Wilmarth, JR. (eds), *The Panic of 2008 – Causes, Consequences and Implications for Reform* (Edward Elgar Publishing Ltd 2010) 170.

³ Others would include HBOS, the UK's largest mortgage lender subsequently rescued by a rival. The UK also became the majority owner of two of the country's top four banks: the Lloyds Banking Group and Royal Bank of Scotland (RBS).

⁴ Take Citibank for example: its yield on real-estate loans increased from 6 per cent in 2005 to 18 per cent by 2006 at a time when other large banks were reporting yields of 7 per cent on similar loans: William C Handorf, 'Lessons from 2008 US bank failures' in Laurence E Mitchell and Arthur E Wilmarth, JR. (eds), *The Panic of 2008 – Causes, Consequences and Implications for Reform* (Edward Elgar Publishing Ltd 2010) 174.

risky in another; the type of stewardship engagement such Codes attempt to promote cannot work in practice due to a number of structural limitations faced by investors.⁵ Shareholders do not possess a great degree of control over long-term plans or the day-to-day matters; it is not their role to micromanage or 'nit-pick' management. That is because the dispersed ownership model relies on the appointment and performance of high quality directors who enjoy significant autonomy in the exercise of their functions without the need for thorough supervision by owners.⁶ That said, we have not seen many 'high quality' bankers openly talking about their moral and professional past failings and future moral and professional responsibilities. We have not seen much deliberation by them. Their usual defense is that due to the pre-crisis economic conditions they were acting as best as they could – the primary goal being the chasing of profit. Within this atmosphere there was little questioning on the level of risk bankers were taking. Little questioning on the 'whys' – why would these people assume such excessive risks? Why were they not disturbed by the severe consequences of their actions upon the whole financial system?

In one sense, the main ambition of capitalism is the pursuit of profit, and bankers were given every incentive and opportunity to do just that. But the capitalistic pursuit of money is not enough to justify bankers' actions, particularly the type of excesses that dominated the majority of banking institutions.⁷ The 2008 global crisis was the worst economic disaster since the 1929 Great Depression. The cause has not been located to no one single event; instead, it happened because of a number of events, each with its own activating device that put together, resulted in the near ruin of the banking system.⁸ A plethora of theories spawned on the crisis' origins and extent; numerous

⁵ Paul L Davies, 'Institutional Investors: A UK View' [1991] 57 Brooklyn Law Review 129, 140; Demetra Arsalidou, *Rethinking Corporate Governance in Financial Institutions* (Routledge 2015).

⁶ David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities – Final Recommendations* (London 26 November 2009) <http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf> accessed 12 May 2016, 79.

⁷ Such as those that were linked with the securitization business.

⁸ The underlying cause of the global financial crisis was an amalgamation of debt and mortgage-backed assets. The immediate cause originated in the US as a result of the high default rates on 'subprime' and adjustable rate mortgages. The amount of subprime mortgage debt continued to grow into the early 2000s, around the same time the Federal Reserve Board began to reduce interest rates considerably to avoid a recession. A growth in loan incentives and a long-term trend of house prices rising incentivised borrowers to accept mortgages they would not ordinarily accept, on the expectation that they would obtain more favourable terms in future. However, the increase of the interest rates in 2006 and the (noteworthy) drop in housing prices resulted in refinancing becoming more difficult. As housing prices fell, subprime borrowers began to default on loans that were worth more than their homes, and this accelerated the decline in house prices. Consequently, there was a steep rise in defaults and force closure activity. When investors tried to unload the subprime mortgages they

and diverse as they were⁹, the causes were also probably closely linked to the behaviour of bankers. According to behavioural decision theory the global financial crisis is, to a large degree connected to behavioural limitations and socio-psychological factors.¹⁰ In fact, numerous post-crisis reports point to the fact that plenty of corporate boards in Europe, the US and elsewhere were characterised by incompetence, greed and hubris. Bankers' excessive greed led them to fall into the temptation of securitisation. Their weak professional and ethical responsibility offset their predisposition towards self-indulgence and excess. It also led them to think short-term. Many appeared ignorant of financial products. All the while they were acting in an environment that was 'rich in over-confidence, over-optimism and the stifling of contrary opinions'.¹¹

This paper does not provide a full account of the financial crisis' causes - these have been deliberated greatly in literature. Rather, it questions how global businesses can alter their attitudes (that saw them placing the short-term share price above everything else) to make them more ethical and transparent. We need to question what went

purchased, there were no buyers in the market. This created a series of subprime lender failures – this in turn, caused a liquidity contagion that climbed all the way up in the banking world. Lehman Brothers and Bear Stearns, two large investment banks collapsed as a result of their close contact to the subprime debt with many others failing later on, not only in the US but in Europe and around the world too. More would have failed had it not been for governments in the US, Europe and the UK stepping in to save these banks with taxpayer's money.

⁹ Although corporate governance deficiencies played an important role in this regard, it is crucial to emphasise that it is far from certain that they were the main instigators of the financial crisis - in fact, there are empirical works that give evidence to the contrary, pointing to that this latest crisis' most important precipitating factor was monetary policy: Allen N. Berger, Christa H.S. Bouwman, 'Bank Liquidity Creation, Monetary Policy, and Financial Crises' [2010]

<<http://web.mit.edu/cbouwman/www/downloads/BergerBouwmanFinCrisesMonPolicyAndBankLiqCreation.pdf>> accessed 06 July 2017. Also See, Simon Deakin, 'Corporate Governance and Financial Crisis in The Long Run' (Working Paper No. 417 Centre for Business Research, University of Cambridge, December 2010). In addition, the lack of 'trust' in the activities of banks is also a huge factor here. As Ramskogler notes, 'as soon as trust in the underlying assets started to erode, the fragile structure imploded. As a matter of fact, the creation of deposit equivalents outside the realm of deposit insurance and the lack of a lender of last resort led to a new version of a classic 19th century bank run. The effects of these ruptures are still felt today': Paul Ramskogler, 'Tracing the Origins of the Financial Crisis' [2015] OECD Journal: Financial Market Trends <<http://dx.doi.org/10.1787/fmt-2014-5js3dqmsl4br>> accessed 16 June 2017.

¹⁰ For an excellent analysis see Emiliós Avgouleas, 'The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform' [2009] 6(4) European Company and Financial Law Review 440.

¹¹ This is according to the UK's Treasury Select Committee: House of Commons, Treasury Committee, *Banking Crisis: Dealing with the Failure of the UK Bank*. (HC 416, Seventh Report of Session 2008-09) - Report, Together with Formal Minutes London: TSO (The Stationery Office), p. 3. Also the OECD, in its report on the financial crisis, concluded that to an important extent, the crisis was caused by failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking: Organisation for Economic Co-Operation and Development, OECD Steering Group on Corporate Governance, *The Corporate Governance Lessons from the Financial Crisis*. (1995-2864, Prepared by G. Kirkpatrick – 2009).

wrong in the banks themselves, whether in Europe, the UK or the US; this will be substantiated in the paper by referring to three possible causes of a financial catastrophe that are linked to bankers' attitudes and mindsets: bankers' excessive greed that leads them to fall into ruinous temptations such as securitisation and short-termism, their behavioural limitations such as overconfidence and over optimism, and finally their ignorance and obliviousness of financial nuances and related risks. Next, the paper considers an alternative model to confronting bankers' deficiencies that is more sustainable in the long run: the tool of education. When there is so much disapproval of companies for their lack of corporate social responsibility, education can help significantly. The role of education is three-fold. First, it can alert future leaders on the positives of acting selflessly and for socially responsible goals; this will help restore integrity back into banking whilst underlining the power of ethics-based corporate cultures. Second, current and future leaders need to attain a better understanding of what the law actually says: that they must promote the company's best interests – and not the shareholders' short-term interests – a matter frequently ignored within business practice. Last but not least, via education leaders can be taught that they are prone to behavioural weaknesses and that they also tend to exhibit ignorance of financial nuances and related risks, both of which can have catastrophic consequences on the financial world as a whole; such an insight can help them prepare themselves better for the temptations faced when performing managerial tasks of such great magnitude. All in all these 'educational measures' led from the bottom to the top, are mundane and straightforward. But simplifying our solutions, and a dose of common sense can go a long way to tackle the anomalies with respect to bankers' attitudes. Whatever we do, we must do so in order to reinstate confidence in and respect for the banks - not the easiest of tasks, and a journey up a steep mountain no doubt.

2. Managing a Large Bank in the Globalised World: Europe, the UK and the US

Banking institutions within Europe, the UK the US come in different shapes and sizes, and develop and contract along numerous magnitudes. Yet, a common trait amongst them is that banks are corporations, and the enabling rules for their composition, management and financing are relatively flexible. But what does it really mean to manage a large bank? To provide some context it is necessary to run an investigative

analysis of the two dominant types of banks of the western world: commercial banks and investment banks. These two distinct divisions of the banking industry provide largely different services – a distinction that has come under scrutiny since the financial crisis' emergence, with many experts suggesting their functions must be reassessed and the roles reconsidered.¹² From this perspective there are two key temptations linked to modern banking: securitisation and short-termism. Partly accountable for the crisis of 2008 and completely unlike traditional banking, these temptations help design a corporate culture that is dysfunctional and simply flawed, whether in a small or large country.¹³

2.1. Commercial Banks and Investment Banks

The functions of a commercial bank are typically straightforward especially compared to those of an investment bank. Commercial banks are involved with deposit taking and making loans - in effect they act as managers for deposit accounts for businesses and individuals. They tend to concentrate on business accounts and make public loans through deposit money held by them. On the other side are investment banks; these are more complex organisations, their main business being securities underwriting, M&A advisory, asset management and securities trading.¹⁴ Investment banks advance the acquisition and sale of bonds, stocks and other investments, and also help companies make initial public offerings. Typically their clients include pension funds, corporations, governments and hedge funds. Certainly for such banks size matters: the larger their size, the more numerous and worldwide are their clients. Also,

¹² There is plenty of interesting scholarly literature on this, such as John Armour, Daniel Awrey, Paul Lyndon Davies, Luca Enriques, Jeffrey N. Gordon, Colin P. Mayer, Jennifer Payne, *Principles of Financial Regulation* (Oxford University Press 2016); Gerard Caprio (ed), *Handbook of Safeguarding Global Financial Stability: Political, Social, Cultural, and Economic Theories and Models* (Elsevier 2012).

¹³ Indeed, the global financial crisis is a harsh reminder of the multi-layered nature of crises. They hit small, large, poor and rich countries equally. As Reinhart and Rogoff write, 'financial crises are an equal opportunity menace': Karmen M. Reinhard and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton Press 2009).

¹⁴ The world's top investment banks are: Barclays, BofA Merrill Lynch, Warburgs, Goldman Sachs, Deutsche Bank, JP Morgan, Morgan Stanley, Salomon Brothers, UBS, Credit Suisse, Citibank and Lazard. In the vicinity of London investment banks can be divided into three key categories: a) the US banks such as Citigroup, JP Morgan, Goldman Sachs and Morgan Stanley, b) the EU and UK banks, such as Credit Suisse, Deutsche Bank and UBS and c) the specialist independent investment banks, such as Lazard and Rothschild.

the more their connections within the market, and this means the higher their chances of profiting through the matching of buyers and sellers, especially for transactions that are particularly unique in nature. This gives them a great degree of international significance. In relation to functions and activities, compared to commercial banks investment banks are more multifaceted in nature. Normally investment bankers identify new business opportunities, conduct thorough research into market conditions and trends, collaborate with finance executives of other organisations, and work alongside numerous teams of professionals such as accountants and lawyers. They usually carry out financial modelling in order to create and present to the clients suitable financial solutions. Corporate investment bankers tend to work in teams, each team engaged in specific transactions or specific market sectors. More specifically, their functions consist of two key parts: origination and execution. Origination refers to the assessment of a deal's desirability, a task that requires the use of complicated financial models to calculate possible outcomes (if it is to be done right). It also requires a thorough and in-depth appreciation of the particular sector or sectors under consideration. Execution refers to the structuring and negotiation of a deal's complex terms. Even though origination and execution are distinct, the teams assigned each task have to work closely with one another during each phase. This helps them benefit from relevant market intelligence and expert information.

In so far as qualifications go, standards are high. Candidates everywhere and particularly in the continents of Europe and America, must hold a strong academic performance in order to stand a realistic chance of a career in the investment-banking sector. Discipline-wise investment banks tend to employ graduates from a range of sectors and not just those whose degrees are finance-focused, although typically successful candidates are former financial advisers, traders or even salespersons. Certainly (the generously-rewarded) investment bankers come from a variety of backgrounds but a strong foundation in mathematics is advantageous: not only it helps them get a job in the banking sector, a maths background can prove useful once in the job itself. In addition, an MBA degree is an extremely beneficial qualification to take as it enhances a candidate's chances considerably; graduates of MBA programs have significantly higher chances of gaining and retaining a high-level management post. In fact, it is estimated that approximately seventy percent of the MBA holders worldwide are senior

managers, board directors and investment bankers.¹⁵ Unquestionably without a good degree entry to the investment-banking sector is highly unlikely.

2.2. Job Temptations linked to Modern Banking Practices: Securitisation and Short-Termism

Orthodox financial economics examines the way individuals and institutions make decisions under uncertainty. This discipline disapproves of legal constraints; in place of the legal status quo it opts for a deregulatory normative agenda.¹⁶ That is because of the traditional economic assumption that people behave rationally and with logical, clear thought. Rational actors do not gamble away their institutions money unless the expected rewards overshadow the possibility of losses occurring in future – in other words, if the eventual benefits are, on balance, worth their while. The assumption that individuals make rational economic decisions has gone largely unchallenged partly because of its convenient nature (at least until recently that is). It has certainly aided economic theorists make meaningful contributions about individual behaviour; it has given self-regulation space to flourish and dominate, and has also helped develop the idea that bankers do not need their behaviour to be ‘controlled’: they are sufficiently rational in their actions and perfectly cognizant of their choices’ risks and returns.¹⁷

But often, this is not so. The job of the investment banker is full of temptations. The pressure to reach annual goals together with the regular incrementing of those goals being reliant on performance evidently motivates bankers to use inappropriate methods to ‘fulfil’ their roles. From this perspective, there are currently two key problems with modern banking: securitisation and short-termism. These two, partly accountable for the financial crisis of 2008, are completely unlike traditional banking. Traditional banking expects banks to base loan decisions on a personal acquaintance and long-term relationship held with the borrower. This is in contrast to ‘securitization’: in fact, the phenomenon of securitization perfectly embodies what can go wrong with

¹⁵ Maria Alexandra Bujor, ‘5 Good Reasons to Do an MBA’ <<http://www.mastersportal.eu/articles/340/5-very-good-reasons-to-do-an-mba.html>> accessed 09 May 2016.

¹⁶ Donald C Langevoort, ‘Behavioral Approaches to Corporate Law’ in Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar 2012) 3.

¹⁷ Joseph Stiglitz, ‘Regulation and Failure’ in David Moss and John Cisternino (eds), *New Perspectives on Regulation* (The Tobin Project 2009) 16.

modern banking; personal relationships and community interests diverging to a notable degree. There is no personal relationship between the lender and the borrower; rather, the relationship is symbolised by a hands-off approach with short-term results as the main aim. The affiliation between the two parties is characterised by anonymity and trust plays no role in a relationships' formation.¹⁸ But exactly happens during the securitisation process? The term 'securitization' is defined as "the increased use of the securities markets for the extension of credit and in particular to the specific procedure for dedicating the interest and the principal payments from a specific pool of loans to the issuance of securities".¹⁹ During securitization there is an eruption in the use of complicated and obscure derivative products. Certainly the housing bubble of 2007 provided the ideal conditions for securitization to flourish: in the years before the crisis' climax we saw the sale and promotion of exotic mortgages to millions of individuals who were completely unaware of the implications of this practice.²⁰ Investment banks would purchase the mortgages, repackage them and then sell them to numerous investors worldwide, largely pension funds and non-profit organisations.²¹ Banks used securitization to package subprime loans into ambiguous derivative products that were later on sold to financial institutions in the shadow banking system, thereby creating the perfect platform for a full-blown economic catastrophe.

Still, securitization is not illegal; the crucial question therefore, is whether bankers understand exactly the complexities and repercussions of this method. In the financial catastrophe of 2008 banks' risk assessment in places like the US, the UK and Europe more widely, was poor; banks would routinely fail to inspect the credit history, financial security or income of borrowers. Subprime loans were passed on to the secondary loan market within months after initiation, with little risk to banks: the risk was passed on to the parties that purchased the secured mortgages. In effect the investors who purchased these securities were basically lending money to homeowners with little or

¹⁸ But as Ramskogler notes, as soon as trust in the underlying assets starts to erode, the fragile structure implodes: Paul Ramskogler, 'Tracing the Origins of the Financial Crisis' [2015] OECD Journal: Financial Market Trends <<http://dx.doi.org/10.1787/fmt-2014-5js3dqmsl4br>> accessed 16 June 2017.

¹⁹ Martin H Wolfson and Gerald A Epstein (eds), *The Handbook of the Political Economy of Financial Crises* (OUP 2013) 35.

²⁰ Viral Acharya, Phillip Schnabl and Gustavo Suarez, 'Securitization Without Risk Transfer' [2013] 107 Journal of Financial Economics 515.

²¹ This repackaging is, in fact, a very crucial step in the method of securitization.

no knowledge of the homeowners' identity; rather, they expected the banks that sold them the products to perform a thorough identity check. But this was not always so; banks had little or no motivation to do so. Banks were only concerned with getting rid of the mortgage-backed securities as quickly as possible.

Equally destructive, particularly amongst European, UK and US banks, is the practice of 'short-termism'. Directors are expected to promote "sustainable value" in order to benefit all stakeholders, and that should include the local community in which the company functions and operates.²² But because institutions invest in order to receive a financial return directors tend to forget that they are not to solely promote immediate financial interests – at least not by law. This is worsened by the fact that if any instructions are given to fund managers they are generally "on the basis of high, medium or low financial risk and not on the basis of sustainable growth, social capital or how a company promotes relational operations".²³ Although the cause of the crisis has not been located to no one single event²⁴ large numbers of commentators as well as numerous post-financial crisis research reports maintain that over-leverage and excessive risk-taking were the underlying reasons for the crisis, and this was principally due to pressures from shareholders to focus on quarterly earnings.²⁵

²² Arad Reisberg, 'The Notion of Stewardship from a Company Law Perspective: Re-defined and Re-assessed in Light of the Recent Financial Crisis?' [2011] 18 Journal of Financial Crime 126, 135.

²³ Arad Reisberg, 'The Notion of Stewardship from a Company Law Perspective: Re-defined and Re-assessed in Light of the Recent Financial Crisis?' [2011] 18 Journal of Financial Crime 126, 134.

²⁴ The global economic crisis happened because of a number of events, each with its own activating device that together, caused the near ruin of the banking system. As noted in the introduction to this paper, the underlying cause was the amalgamation of debt and mortgage-backed assets. The immediate cause originated in the US as a result of the high default rates on 'subprime' and adjustable rate mortgages. It is also crucial to note that although corporate governance deficiencies contributed to the crisis, it is far from certain that they were the main instigators of the financial crisis - in fact, there appear to be empirical works that give evidence to the contrary. There is empirical evidence that points to that the 2008 crisis' precipitating factor was monetary policy: Allen N. Berger, Christa H.S. Bouwman, 'Bank Liquidity Creation, Monetary Policy, and Financial Crises' [2010]

<<http://web.mit.edu/cbouwman/www/downloads/BergerBouwmanFinCrisesMonPolicyAndBankLiqCreation.pdf>> accessed 06 July 2017. Also See, Simon Deakin, 'Corporate Governance and Financial Crisis in The Long Run' (Working Paper No. 417 Centre for Business Research, University of Cambridge, December 2010). In addition, the lack of 'trust' in the activities of banks is also a huge factor here. As Ramskogler notes, 'as soon as trust in the underlying assets started to erode, the fragile structure imploded. As a matter of fact, the creation of deposit equivalents outside the realm of deposit insurance and the lack of a lender of last resort led to a new version of a classic 19th century bank run. The effects of these ruptures are still felt today': Paul Ramskogler, 'Tracing the Origins of the Financial Crisis' [2015] OECD Journal: Financial Market Trends <<http://dx.doi.org/10.1787/fmt-2014-5js3dqmsl4br>> accessed 16 June 2017.

²⁵ Andrew Keay, 'The Global Financial Crisis: Risk, Shareholder Pressure and Short-Termism in Financial Institutions' (Working Paper Centre for Business Law and Practice, School of Law, University of Leeds, August 2010) <<http://www.law.leeds.ac.uk/assets/files/research/events/directors-duties/keay-the-duty-to-promote-the-success.pdf>> accessed 16 April 2016, 30; Michael Lipton, Timothy Mirvis and Jay Lorsch, 'The Proposed Shareholder Bill of Rights Act of 2009' [2009] Harvard Law School Forum on Corporate Governance and

Walker has even suggested that bankers' short-term behaviour was the financial crisis' catalyst.²⁶ According to Blundell-Wignall et al., over the past decades, the opportunities to increase leverage in the financial sectors of many industrialized economies rose to a large extent, a crucial reason being the excess liquidity caused by the factors such as reserve accumulation and low policy rates.²⁷ It is thought that the search for immediate monetary gratification at the expense of future returns has driven investors and directors for years.²⁸ The fundamental problem lies in the theoretical basis of the short-term approach: the manager, as agent, is motivated to act for the shareholder who is constantly pushing for short-term profits. But directors can also benefit from short-termism; it is a form of enlightened self-interest because executive remuneration is often linked to the making of a quick profit. Yet, short-termism has long-term disbenefits and costs and is a guaranteed way to destroy company value.²⁹ Rather than pushing for real meaningful progress, managers constantly chase quick solutions that ultimately fail to benefit the company or the shareholders long-term. Take the US system for example: although it has enjoyed great prominence for a long time, its 'traditional' practices proved inadequate in recent years.³⁰ Despite the plethora of positives, the system encourages excessive risk-taking and short-sighted behaviour with little concern as to the consequences of short-

Financial Regulation < <http://blogs.law.harvard.edu/corpgov/2009/05/12/the-proposed-%E2%80%99Cshareholder-bill-of-rights-act-of-2009%E2%80%9D/>> accessed 16 May 2016; Alessio M Paces, 'Consequences of Uncertainty for Regulation: Law and Economics of the Financial Crisis' [2010] 4 European Company and Financial Law Review, 479; Andrea S Ginevri, 'The Rise of the Long-Term Minority Shareholders' Rights in Publicly Held Corporations and its Effect on Corporate Governance' [2011] 12 European Business Organisation Law Review 587.

²⁶ David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities – Final Recommendations* (London 26 November 2009) <http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf> accessed 12 May 2016, 75.

²⁷ Adrian Blundell-Wignall, Paul Atkinson and Se Hoo Lee, 'The Current Financial Crisis: Causes and Policy Issues' [2009] 2008/2 OECD Journal: Financial Market Trends <<http://dx.doi.org/10.1787/fmt-v2008-art10-en>> accessed 20 August 2017. Also see Alberto Manconi, Masimo Massa and Ayako Yasuda, 'The Role of Institutional Investors in Propagating the Crisis of 2007-2008' [2012] 104 Journal of Financial Economics 491.

²⁸ This is according to the Kay review: The Kay Review, *The Kay Review of UK Equity Markets and Long-Term Decision Making Interim Report* (Pub Ref: URN 12/631, Feb 2012) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31544/12-631-kay-review-of-equity-markets-interim-report.pdf> accessed 22 April 2016.

²⁹ Andrea S Ginevri, 'The Rise of the Long-Term Minority Shareholders' Rights in Publicly Held Corporations and its Effect on Corporate Governance' [2011] 12 European Business Organisation Law Review 587, 602; Demetra Arsalidou, 'Shareholders and Corporate Scrutiny: the Role of the UK Stewardship Code' [2012] 9(3) European Company and Financial Law Review 342.

³⁰ Monks suggests that there has been little progress in recent years and that it can no longer be seen as a successful system despite all the effort put into its improvement, particularly during the 1990's: Robert AG Monks, 'Corporate Governance - the Wrong Way and the Right Way' [2005] 13 *Corporate Governance: An International Review* 108.

term actions. The 2001 Enron collapse for instance, one of the darlings of post 1980's American corporate law, happened despite the clever features of the US system. The compensation and performance management systems of both Lehman and Enron,³¹ designed to retain and motivate the most valued employees, had cash flows that noticeably exceeded the value of the executives' initial holdings.³² All these helped design a dysfunctional corporate culture that became too fixated with short-term earnings to enhance bonuses.³³

3. Bankers' Imperfections and their Link to Financial Catastrophes in Europe, UK, and the US

A number of concerns stem from the above. Above all, it is obvious that running an investment bank is a particularly complex job; a plethora of skills, knowledge and experience is what is needed to do the job right. Intriguingly what often lies behind the formation of a multifaceted business structure is the desire to reduce or eradicate altogether potential liability for any wrongful acts inflicted on others by the firm itself.³⁴ Whatever the underlying reasons, the question after formation is whether those employed to manage large institutions in Europe, America or elsewhere (such as investment banks) are capable of *properly* undertaking and fulfilling their obligations, thereby circumventing potential liability for breach of duty. Ultimately, investment banks are not known for their focus on training; in fact it is typical for a banker's career development and training to take a backseat – after all, they are expected to work, not learn.³⁵ This means their pre-existing qualifications are key. Therefore, it is crucial to ask: do they have the qualifications needed? Do they understand the complexities of the tasks they are bound to face once in the job itself?

Operating at a fairly high level of abstraction, the fundamental question is why bankers behave the way they do. Essentially many things can go wrong; bankers'

³¹ As well as numerous other firms, notably Bear Stearns.

³² Lucian A Bebchuck, Alma Cohen, Holger Spamann, 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008' [2010] 27 Yale Journal on Regulation 257.

³³ Bethany McLean and Peter Bethany, *The Smartest Guys in the Room* (Portfolio Trade 2004) 241. It is astonishing that the top 200 highest-paid employees of Enron received \$193 million from salaries, bonuses, and stock in 1998, and by 2000 the amount increased to \$1.4 billion.

³⁴ Eric W Orts, *Business Persons – A Legal Theory of the Firm* (Oxford University Press 2013) 192.

³⁵ Andrew Gutmann, *How to Be an Investment Banker: Recruiting, Interviewing, and Landing the Job* (Wiley 2015).

understanding of their products' complexities can be weak, their behaviour can be subject to serious limitations that prevent the proper performance of their roles and functions, and last but not least, any self-centred job 'strategies' can seriously harm rather than benefit institutions. But answers are not that easy; for example, if we take the issue of securitization, how to deal with this type of business is a question that raises serious difficulties. What can be done about this tempting management style? From a finance / regulatory perspective there are measures that could prove effective, such as more regulation during the stages leading to the restructuring stage.³⁶ As Stiglitz opines, having provisions to deal with a well-organized payment method would be a strong second measure; this would involve a system "in which the bank facilitates transactions, transferring its depositors' money to those from whom they buy goods and services), and the assessment and management of risk and making loans". The second core function is linked to the first, in the sense that "if a bank makes poor credit assessments, or if it puts too much money into risky ventures that default, it can no longer make good on its promises to return depositors' money."³⁷

Clearly, mismanaging capital is not good for either side – firms and bankers on the one side, society on the other. It is also true that the incentive structures of the financial market system need restructuring; in order for the restructuring to work however, other things have to happen first. But before we deliberate on what can be done about bankers' temptations and deficiencies, we need to understand why bankers behave the way they do.

3.1. Behavioural Causes and Instigates

Banks, and especially the bankers who represent them, have tendencies towards clashing objectives, muddled internal incentives and ineffective oversight.³⁸ But why do they even display these characteristics? Why do bankers continuously fall into the same pattern of underestimating the risks associated with managing large institutions?

³⁶ Joseph Stiglitz, *Freefall – America, Free Markets and the Sinking of the World Economy* (Tantor Media 2010), 22.

³⁷ Joseph Stiglitz, *Freefall – America, Free Markets and the Sinking of the World Economy* (Tantor Media 2010), 22.

³⁸ A. Michael Froomkin, 'Reinventing the Government Corporation' [1995] *University of Illinois Law Review* 543, 618-633.

Although questions remain about which part of the financial system failed most cruelly, most observers agree that behavioural factors performed a central part in the failures of British, European and American banks in 2008.³⁹ Certainly, understanding with precision why bankers act the way they do is vital in this debate. Due to the weakness of ownership and control, bankers are able to engage in forms of behaviour that do not advance company wealth and that are unproductive from the perspective of both institutions and societies alike.⁴⁰ Some argue self-interest is the reason for this, because reckless risks can (and frequently do) result in a personal benefit to the one assuming the risk. Still, self-interest alone cannot be the sole driving force of this kind of behaviour; it is too simplistic as a justification. By undervaluing the risks involved bankers risk their own positions and reputations: personal liability, job losses or even imprisonment are very likely consequence. There are other, more complex behavioural causes that can be deliberated upon that offer more convincing explanations as to the reasons bankers behave the way they do.⁴¹

To begin with, noteworthy perspectives are provided by the prospect theory: this is a behavioural economic theory that offers some intriguing insights into the behaviour of bankers. Developed through Kahneman and Tversky's ground-breaking research into the motives of market participants, prospect theory considers the way people manage risks under uncertainty. It offers two notable explanations of market participants' behaviour: people's tendency to seek risk at times when losses are highly likely, and people's tendency to be risk-averse in situations where a gain is possible. Through laboratory experiments prospect theory identifies the key reasons irresponsibility is triggered. Market participants make decisions based on the potential value of losses

³⁹ Alan S. Blinder, Andrew W. Lo, Robert M. Solow, *Rethinking the Financial Crisis* (Russell Sage Foundation 2012); Robert E. Grosse, *The Global Financial Crisis – A Behavioral View* (Thunderbird School of Global Management 2010). For a study of behavioural factors more generally see: David Sharfstein and Jeremy Stein, 'Herd Behavior and Investment' [1990] 80(3) *American Economic Review* 465; Dale Griffin and Amos Tversky 'The Weighing of Evidence and the Determinants of Overconfidence' [1992] 24 *Cognitive Psychology* 411; Abhijit Banerjee, 'A Simple Model of Herd Behavior' [1992] 107 *Quarterly Journal of Economics* 797.

⁴⁰ John E Parkinson, *Corporate Power and Responsibility* (Clarendon Press 1993) 63.

⁴¹ By way of background, the methodological assumptions of orthodox financial economics, i.e. that of individual rationality and market efficiency, came to be challenged largely with the seminar work of Kahneman and Tversky and continued through a scholarship revolution in the 1990's. Kahneman and Tversky, who received a Nobel Prize in economics in 2002, analysed the host of irrationalities that characterise individuals in economic settings, and helped the development of a subfield of economics called behavioural economics. See Daniel Kahneman, 'Maps of Bounded Rationality: Psychology for Behavioral Economics' [2003] 93 *American Economic Review* 1449; Amos Tversky and Daniel Kahneman, 'On the Psychology of Prediction' [1973] 80 *Psychological Review* 237.

and gains rather than on the most likely (and final) outcome, and they assess these losses and gains using 'heuristics'.⁴² Heuristics are mental shortcuts or rules of thumb used to simplify (or even oversimplify) decisions taken under uncertainty.⁴³ Decision-makers who are convinced of their institutions' imminent breakdown tend to take remarkably high risks to avoid a loss. They opt for risky routes in order to side step the negative consequences of their own reckless actions.⁴⁴ The Barings bank is a classic illustration of this type of behaviour: once a reputable financial institution, it collapsed due to the actions of its floor trading manager, Nick Leeson. Leeson made a number of unauthorized speculative trades that proved highly profitable for the bank at first, but with the passage of time caused Barings severe damage. In his attempt to recoup his losses and retrieve the amounts already lost, Leeson started taking even higher risks. He showed no hesitation in doing so because the quantum of loss far exceeded his relative risk threshold.⁴⁵

In addition, empirical psychology literature offers some interesting perspectives on the tendency of bankers to assume reckless risks. Insights from behavioural economics, cognitive psychology and neuroscience provide a different approach to management motivation from that deliberated so far. Behavioural psychology considers the underlying factors of reckless economic behaviour; according to various studies individuals are subject to cognitive errors or cognitive biases and information asymmetries. Bankers are predisposed to numerous behavioural biases that influence their ability to act rationally.⁴⁶ Psychologists explain these cognitive errors, collectively

⁴² Daniel Kahneman and Amos Tversky, 'Prospect Theory: an Analysis of Decision under Risk' [1979] 47 *Econometrica*, 263. Daniel Kahneman, won a Nobel Prize in Economics for his work developing Prospect theory. Also, see S Trevis Certo, Brian L Connolly and Laszlo Tihanyi, 'Managers and Their Not-So Rational Decisions' [2008] 51 *Business Horizons* 113.

⁴³ For a discussion on 'heuristics' see: Demetra Arsalidou, 'Institutional Investors, Behavioural Economics and the Concept of Stewardship' [2012] 6(6) *Law and Financial Markets Review* 410; Daniel Kahneman and Amos Tversky, 'Prospect Theory: an Analysis of Decision under Risk' [1979] 47 *Econometrica*, 263; Amos Tversky and Daniel Kahneman, 'On the Psychology of Prediction' [1973] 80 *Psychological Review* 237. Also, see Emiliós Avgouleas, 'The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform' [2009] 6(4) *European Company and Financial Law Review* 440.

⁴⁴ Also, see: Richard H Thaler, 'Toward a Positive Theory of Consumer Choice' [1980] 1 *Journal of Economic Behavior and Organization* 39; Jonathan Mercer, 'Prospect Theory and Political Science' [2005] 8 *Annual Review of Political Science* 21; Mercer lists several examples of the loss aversion bias from political science; Terrance Odean, 'Are Investors Reluctant to Realize their Losses?' [1998] 53 *Journal of Finance* 1775: Odean describes the practical implications of loss aversion.

⁴⁵ Jeffrey Delmon, *Project Finance, BOT Projects and Risk* (Kluwer Law International 2005) 22.

⁴⁶ Jonathan Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2008) 69. See also Charles P Kindleberger and Robert Aliber, *Manias, Panics and Crashes: A History of the Financial*

known as confirmation biases, by looking at several factors such as emotional and cultural factors; studies suggest that embarrassment, persistence and hope may incite cognitive errors, whereas superstition and tradition may aggravate the cultural forces behind one's behaviour. Emotions and instincts play a key part in the decision-making process,⁴⁷ resulting in herd effects and irrational momentum swings. Crucially over-optimism and confirmation bias are key ingredients in analysing economic behaviour. People tend to display overconfidence in their own abilities and prefer not to search for evidence that can potentially contradict their pre-set ideas. In fact, any evidence opposing their assumptions tends to be ignored. Excessive pride and self-confidence collectively known as hubris are also common characteristics of market participants. Undoubtedly the behaviour of many during the 2008 financial catastrophe pointed to signs of overconfidence and even arrogance, traits that contributed to the misjudgements that were made at the time. These are complex and multifaceted issues; what can be said with certainty is that behavioural biases can produce very distinctive dynamics within corporations.

Nevertheless, there are many prominent critics who doubt the value of behavioural economics.⁴⁸ That firms have institutional incentives to de-bias is critical to the general objections of this field. Importantly it would have to be shown that the alleged bias is a commonly occurring phenomenon in the general population and not a mere artefact of experimental design. The institutional environment in which these decisions are made plays a crucial role too: this environment would need to contain no 'de biasing' constraints such as peer review, off-setting contractual incentives and external monitoring. But it would be hard to assess such factors. Chief executive officers and

Crises (5th edn, John Wiley & Sons 2005): interestingly, in this book it is argued that irrational behaviour is what links the different financial disasters that have occurred in the markets.

⁴⁷ Emiliós Avgouleas, *Governance of Global Financial Markets – the Law, the Economics, the Politics* (Cambridge University Press 2012) 121.

⁴⁸ See Richard Posner, 'Rational Choice, Behavioral Economics and the Law' [1998] 50 *Stanford Law Review* 1551; Roberta Romano, 'A Comment on Information Overload, Cognitive Illusions and their Implications for Public Policy' [1986] 59 *Southern California Law Review* 313; Donald C Langevoort, 'Behavioral Approaches to Corporate Law' in Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar 2012) 3. It should be noted that there is inadequate empirical data to construe an empirically confirmable theory on incentives. Behavioural scientists need to devote more time researching bankers' behaviour- we need a better appreciation of the *strategies* used by market participants and especially bankers. What strategies do they use and how are their decisions *actually* made? It is crucial we learn more about crowd psychology and the impact of heuristics, and in particular the impact on heuristics on bank directors. For an interesting discussion see: Kath Hall, 'Looking Beneath the Surface: the Impact of Psychology on Corporate Decision Making' [2007] 49 *Managerial Law* 93, 105.

board members are not accidentally selected; they are survivors of high-pressure employment and promotion tournaments.⁴⁹ The presence of irrational biases cannot be presumed since it cannot be shown with certainty that they can survive such tournaments. Yet still, the behavioural insight is important and the idea that cognitive biases exist is by no means unreasonable. Cognitive biases are adaptable and can survive competitive settings; for instance the bias of overconfidence can be highly adaptive and therefore it is reasonable to expect some directors to exhibit this trait in their behaviour. Research suggests that overconfidence and mildly inflated self-esteem (ego) are associated with higher risk tolerance, excessive ambition, persistence and numerous other attributes that come in 'handy' in the banking environment.⁵⁰ The overconfident tend to 'play' with more aggression, generating stronger outcomes, both positive and negative. At the next round those lucky enough to experience the positive results have the confidence to play even harder. If there are enough players around, there will be the fortunate few who are rewarded more frequently than their more 'conservative' colleagues, time and time again.⁵¹

Moreover, according to behavioural psychology directors' undue deference and submissiveness may not be the result of greater operational efficiency but the product of commitment, sunk cost biases and group behaviour.⁵² According to Langevoort directors generally acquiesce, preferring to stay quiet than question a particular course of action. Silence can be interpreted as agreement, thereby reinforcing the status quo via a kind of social proof.⁵³ There is also the matter of loyalty, a weighty characteristic of executive behaviour; in law, the tendency is to focus on the duty of loyalty, imposed on directors to prevent a conflict between their self-interest and shareholder wealth.

⁴⁹ Donald C Langevoort, 'Behavioral Approaches to Corporate Law' in Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar 2012) 5.

⁵⁰ Donald C Langevoort, 'Behavioral Approaches to Corporate Law' in Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar 2012) 5. Also, see Anand Goel and Anjan Thakor, 'Overconfidence, CEO Selection and Corporate Governance' [2008] 63 *Journal of Finance* 2737; Ulrike Malmendier and Geoffrey Tate 'CEO Overconfidence and Corporate Investment' [2008] 60 *Journal of Finance* 2661; Ulrike Malmendier and Geoffrey Tate, 'Who Makes Acquisitions? CEO Overconfidence and the Market's Reaction' [2008] 89 *Journal of Financial Economics* 20.

⁵¹ Donald C Langevoort, 'Behavioral Approaches to Corporate Law' in Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar 2012) 5.

⁵² Donald C Langevoort, 'Behavioral Approaches to Corporate Law' in Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar 2012) 12.

⁵³ Donald C Langevoort, 'Behavioral Approaches to Corporate Law' in Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar 2012) 12; M. O'Connor, 'The Enron board: the perils of groupthink', *University of Cincinnati Law Review* 71, 2003, 1233–1319. Also, see Stanley Milgram, *Obedience to Authority: An Experimental View* (Tavistock Press 1974).

But the loyalty exhibited by directors to other members of the corporate team is also of significance - according to studies resilient multi-directional loyalty partly explains why bankers act the way they act. Evidently, loyalty strongly influences the behaviour of senior executives, with many illustrations of this throughout history. Executives will even contentedly lie in order to protect their teams. They will choose to breach their loyalty to the firms than be disloyal to the other members of the group; that they are risking their reputations, wealth and even freedom is not a reason for them not to act so. They would rather suffer in the name of 'team spirit' and as Langeroot continues, this resilient multi-directional loyalty is the reason why some prefer not to blow the whistle. They choose to continue with the deception than harm the firm's 'insiders', and this at their own personal risk.⁵⁴ In fact, this goes both ways: boards of directors are loyal to the management teams they appoint and management teams are loyal to their boards. For example, the Chief Executive Officer of Enron chose not to blow the whistle upon discovering the fraud, despite the fact that most of the fraud took place during his period of absence from the firm.⁵⁵

3.2. Ignorance is (Not) Bliss

Bankers can have clashing objectives, muddled internal incentives and their oversight can be ineffective.⁵⁶ Yet all the while they are expected to be well-qualified professionals with a first-rate understanding of their bank's operations – this is how their over-generous pay levels are justified (and frequently defended). But apart from the aforementioned behavioural traits, what else causes bankers' performance to disappoint? What other explanations are there for bankers' attitudes and behavioural characteristics? Bankers' attributes can be better understood in terms of the

⁵⁴ Donald C Langevoort, 'Behavioral Approaches to Corporate Law' in Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar 2012) 14. See also Jonathan Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2008) 85.

⁵⁵ For a well-rounded discussion of behavioural issues, see Herbert A. Simon, 'A Behavioral Model of Rational Choice', [1955] 69 *Quarterly Journal of Economics* 69, 99; Herbert A Simon, 'Rational Choice in the Structure of the Environment' in Herbert A Simon (ed), *Models of Man: Social and Rational* (John Wiley and Sons 1957); Cass R Sustein (ed), *Behavioural Law and Economics* (Cambridge University Press 2000); Daniel Kahneman, 'Maps of Bounded Rationality: Psychology for Behavioral Economics' [2003] 93 *American Economic Review* 1449; Amos Tversky and Daniel Kahneman, 'On the Psychology of Prediction' [1973] 80 *Psychological Review* 237.

⁵⁶ A. Michael Froomkin, 'Reinventing the Government Corporation' [1995] *University of Illinois Law Review* 543, 618-633.. Interestingly, at least one crucial root cause has been tracked to low credit standards by credit rating agencies, which were also widely securitized by investment banks.

ideological orthodoxy that conquered the financial service industry in recent years: boards' failure to understand and manage risk.⁵⁷ Bank performance disappoints when management and boards are incapable or unwilling to recognise, evaluate, oversee and control risks in a way that safeguards the safety of their institutions.⁵⁸ The 2008 crisis uncovered serious flaws in this respect: evidence from numerous European, UK, US and international post-crisis enquiries has found that ignorance generally embodied the behaviour of many bank executives; put simply, too many people appeared incapable of understanding the risks involved.⁵⁹ According to a report by the International Corporate Governance Network, boards tolerated perverse incentives and showed little understanding of risk management.⁶⁰ The UK Parliament's Treasury Committee in its report on corporate governance and pay in the City agreed with this conclusion. In the US, institutions' failures were viewed as failures of strategy and risk management tasks primarily due to lack of understanding.⁶¹ Interesting also are the findings of a report by a group of senior supervisors from regulatory agencies: a leading factor to the financial breakdown was the boards' reluctance and / or inability to "articulate, measure and adhere to a level of risk acceptable to the firm".⁶² As we learn, banks such as Fortis Bank in Belgium, Northern Rock in the UK and Lehman Brothers in the US have suffered massive losses partly due to their executives' failure to understand the exact nature of the derivatives, which securitised 'toxic debt' consisting of sub-prime mortgages.⁶³

⁵⁷ International Corporate Governance Network, *Second Statement on the Financial Crisis* (March 2009) <<https://www.icgn.org/>> accessed 10 April 2016.

⁵⁸ William C Handorf, 'Lessons from 2008 US bank failures' in Laurence E Mitchell and Arthur E Wilmarth, JR. (eds), *The Panic of 2008 – Causes, Consequences and Implications for Reform* (Edward Elgar Publishing Ltd 2010) 170.

⁵⁹ House of Commons, Treasury Committee, *Banking Crisis, Reforming Corporate Governance and Pay in the City* (HC 519, Ninth Report of Session 2008–09) - Report, Together with Formal Minutes London: TSO (The Stationery Office). See also Roman Tomasic, 'Raising Corporate Governance Standards in Response to Corporate Rescue and Insolvency' [2009] 2 Corporate Rescue and Insolvency 5.

⁶⁰ Pauline Skypala, 'Time to Reward Good Corporate Governance' *Financial Times* (London, 17 November 2008) 6.

⁶¹ Howard Davies, *The Financial Crisis: Who is to Blame?* (Polity Press 2010) 147. Also see Neil O'Hara, 'Asleep at the Switch? Corporate Boards' Culpability in the 2008 Financial Crisis' (2012) 2 The Investment Professional <<http://www.theinvestmentprofessional.com>> accessed 8 May 2015.

⁶² Senior Supervisors Group reporting to the Financial Stability Board, Bank for International Settlements, *Risk Management Lessons from the Global Banking Crisis of 2008* [2009] <<https://www.financialstabilityboard.org>> accessed 09 May 2016.

⁶³ Demetra Arsalidou, 'The Banking Crisis: Rethinking and Refining the Accountability of Bank Directors' [2010] 4 Journal of Business Law 284.

Let us be fair here. Banks are complex, opaque organisations and the taking of risk is part of their make-up. Bankers however, do not appear to understand the severity of the risks they assume on behalf of their banks. Certainly in the financial crisis of 2008 many derivatives were so complex that even if all the information relating to them had been fully disclosed, most bankers would have been unable to appreciate their real value.⁶⁴ Financial models were and still are, polygonal and can change at a fast speed, making it hard for executives to appreciate their banks' products and the reasons for doing or not doing something. Originating high-risk loans to high-risk mortgagors or purchasing high-risk securities are powerful examples of such distorted risks in economic settings.⁶⁵ The inadequacy of executive knowledge and the general veil of ignorance that tends to symbolise behaviour is certainly one key and common characteristic of bank crises throughout history. In fact these traits have been around for years, with myriads of old and new cases showing ignorance and lack of understanding, varying only in degree and severity.⁶⁶

Take *Re CSTC Ltd*⁶⁷ for example. According to the judge the director was reckless in the performance of his duties and totally 'incompetent'. He had no understanding of the company's operations and no knowledge of how to properly scrutinise the accounts or how best to protect the clients' moneys. He appeared too willing to delegate, leaving serious matters in the hands of others without further supervision by him, a behaviour largely caused by his failure to comprehend the true complexities of his organisation.⁶⁸ In *Re Austinsuite Furniture Ltd*⁶⁹ the director's poor knowledge of his company's affairs was not treated lightly either: the judge characterised the decision to accept a directorship as reckless and unwise, particularly since the director lacked the necessary commercial knowledge and experience. In *Re Linvale* two directors were disqualified for five years after three successive companies of which they were directors went into insolvency. Although they acted honestly, their ignorance

⁶⁴ Joseph Stiglitz, 'Regulation and Failure' in David Moss and John Cisternino (eds), *New Perspectives on Regulation* (The Tobin Project 2009) 15.

⁶⁵ William C Handorf, 'Lessons from 2008 US bank failures' in Laurence E Mitchell and Arthur E Wilmarth, JR. (eds), *The Panic of 2008 – Causes, Consequences and Implications for Reform* (Edward Elgar Publishing Ltd 2010) 174.

⁶⁶ Such behaviour can typically lead to disqualification on the grounds of unfitness under s 6 of the Company Directors Disqualification Act 1986.

⁶⁷ *Re CSTC Ltd* [1995] BCC 173 (ChD).

⁶⁸ *Re CSTC Ltd* [1995] BCC 173 (ChD), 183.

⁶⁹ *Re Austinsuite Furniture Ltd* [1992] BCLC 1047.

of financial matters 'in any technical sense' contributed significantly to the demise of their companies. They showed inability to understand what was actually going, and this at times when they should have been "intelligent enough to have realised that they were, in the case of each company, incurring debts that in probability they would be unable to pay and of using for their own purposes money that ought to have been made over to the Crown."⁷⁰

The case *Re Barings Plc & Others (No 5)*⁷¹ provides one of the most powerful illustrations of directors' ignorance. As result of the unauthorised trading activities of a single trader, the Barings Group collapsed. The bank's governance was characterised by poor delegation, inadequate supervision and a complete lack of expertise in derivatives. All in all, the directors "ought to have known better".⁷² Warning lights were ignored due to the veil of ignorance that dominated their management style; had they paid more attention to the worrying and strong signals however, they would have been alerted of the banks' financial state. Having said that, their knowledge was limited, superficial and totally inadequate to properly equip them for their managerial role.⁷³ Their management style was 'mistaken' and 'misguided'⁷⁴ and their occasional and casual inquiries as to how the trader was generating his reported profits were unsatisfactory. Due to ignorance they lacked the incentive to spend long on key tasks, lacking also the motivation to scrutinise bank strategies. Their general unawareness of what was going on drove them to over-rely on internal advice and obtain little external advice, possibly because the external advice could have been contrary to the dominant views held within the bank. At best the directors' style was mechanical, at worst simply cosmetic.⁷⁵ In the end their failure to equip themselves with a good level of knowledge of Barings' business matters amounted to a clear breach of their management duties. Justice Jonathan Parker was vigorous and emphatic in his conclusions: directors, he said, "have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors". A

⁷⁰ *Re Linvale* [1993] BCLC 654 (ChD), 660: two directors were disqualified for five years after three successive companies of which they were directors, went into insolvency.

⁷¹ *Re Barings Plc & Others (No 5)* [1999] 1 BCLC 433.

⁷² *Re Barings Plc & Others (No 5)* [1999] 1 BCLC 433.

⁷³ *Re Barings Plc & Others (No 5)* [1999] 1 BCLC 433, 528.

⁷⁴ *Re Barings Plc & Others (No 5)* [1999] 1 BCLC 433.

⁷⁵ Howard Davies, *The Financial Crisis: Who is to Blame?* (Polity Press 2010) 148.

manager who does not properly appreciate the business he is expected to manage will be unable to take solid, informed decisions. A limited, general and superficial understanding is clearly insufficient.⁷⁶

The matter of directors' ignorance is reinforced in the subsections below, where two of the most notorious corporate scandals in modern history are examined: Northern Rock and Lehman brothers. Casualties of the 2008 financial crisis, the cases signifying concrete support for the theory of board ignorance articulated here. They have one crucial and fundamental element in common: their executives displayed a general lack of understanding of their banks' operations. And within this environment they also endorsed the design of pay packages that effectively encouraged the excessive risk-taking that we continue to deliberate upon today.

3.2.1. An America Paradigm: Lehman Brothers - A Story of Obliviousness and Idiocy

Lehman Brothers' collapse in September 2008 marks the greatest bankruptcy in US history.⁷⁷ The bank went from being the fourth largest investment bank in the United States⁷⁸ to bankruptcy in less than a year. Its failure caused the credit markets' disintegration, a disintegration that cascaded into the global economic crisis soon after. There are many ironic sides to Lehman's story: in January 2008 the bank reported record revenues of nearly \$60 billion and record earnings in excess of \$4 billion (for its fiscal year ending November 2007); certainly a remarkable achievement to the outside world. However, the façade was not to last. It transpired that the banks' strategy was to invest heavily into the securities market linked to the US sub-prime mortgage market; that is precisely how it gained the title of Wall Street's biggest dealer in fixed-interest trading. Soon, analysts begun to (accurately) predict that confidence in Lehman Brothers would evaporate, particularly after the collapse of Bear Stearns earlier that year. When Lehman's investments begun experiencing rejection due to their high-risk nature, confidence levels significantly dropped. Eventually the bank was

⁷⁶ *Re Barings Plc & Others (No 5)* [1999] 1 BCLC 433, 528.

⁷⁷ For an overview of its collapse, see: Anton R Valukas, *Lehman Brothers Holdings inc., et al*, (Chapter 11 case no. 0813555 (JMP)., Vol. 1) 2010 United States Bankruptcy Court Southern District of New York, Jenner & Block LLP 353, Chicago <<http://jenner.com/lehman/lehman/VOLUME%201.pdf>> accessed 14 April 2016.

⁷⁸ A 'title' held during 2007.

unable to retain the confidence of its lenders and counterparties, a loss of confidence that resulted in the loss of major clients (caused also by the non-transparency of its products), the banks' devaluation by the credit rating agencies, and the suffering of gigantic losses on sub-prime mortgages. Unsurprisingly the bank's total financial catastrophe followed on from that.

While these unprecedented events were taking place, most Lehman executives had little appreciation of the enormity of the problems faced by Lehman. In fact they appeared almost oblivious to the reality of the situation. Many interesting facts transpired from a post-collapse report:⁷⁹ for instance, the bank's risk committee only held two meetings in the financial year of 2007-08. It also transpired that Fuld, one of the banks' main executives, "was always more optimistic about Lehman's condition than the markets were".⁸⁰ Because of his ignorance of key bank transactions the bank routinely failed to provide enhanced disclosures about important financing arrangements called Repo 105 transactions. As he had little understanding of what they were or what they signified, he was not interested in their accounting treatment and therefore did not care to structure or negotiate them. When the Committee on Oversight and Government Reform (US House of Congress) summoned Fuld to explain what had happened, he admitted full responsibility for the errors and misjudgements in the period leading up to the firm's bankruptcy. During the congressional hearing he said that individuals certainly bore some of the blame but the circumstances were equally to blame: there were destabilising factors, rumours, widening credit default swap spreads, naked short-selling, attacks, credit agency downgrades, a loss of confidence by clients and counterparties, and strategic buyers sitting on the side-lines waiting for an assisted deal.⁸¹ This was all too overwhelming

⁷⁹ This is according to Anton Valukas, the Court-appointed examiner: Report of Anton R Valukas, *Lehman Brothers Holdings inc., et al*, (Chapter 11 case no. 0813555 (JMP)., Vol. 1) 2010 United States Bankruptcy Court Southern District of New York, Jenner & Block LLP 353, Chicago <<http://jenner.com/lehman/lehman/VOLUME%201.pdf>> accessed 14 April 2016. Anton Valukas, chairman of the Chicago law firm Jenner & Block, was appointed by a bankruptcy court in New York in 2009 to report on the causes of the Lehman bankruptcy. Valukas prepared the lengthy report with other authors, detailing their perspectives on the workings of Lehman Brothers and possible avenues for actions against the firm's directors and shareholders.

⁸⁰ Report of Anton R Valukas, *Lehman Brothers Holdings inc., et al*, (Chapter 11 case no. 0813555 (JMP)., Vol. 1) 2010 United States Bankruptcy Court Southern District of New York, Jenner & Block LLP 353, Chicago <<http://jenner.com/lehman/lehman/VOLUME%201.pdf>> accessed 14 April 2016.

⁸¹ House of Representatives, Hearing Before the Committee on Oversight and Government Reform, *The Causes and Effects of the Lehman Brothers Bankruptcy* (One Hundred Tenth Congress, Second Session, October 6, 2008).

for the executives, according to Fuld. They were dazed by a series of complex procedures and products and by the highly technical nature of the bank's affairs. In fact, the complexity of the bank's business made it extremely hard for them to understand what they meant or what they were intended to mean.⁸²

It also transpired that the dominant 'board culture' encouraged "delusions of invincibility".⁸³ Senior officers would make business decisions based primarily on their intuitive understanding of the markets than on the firm's quantitative risk limits. Also, even when the bank's financial troubles were at their most severe stage, its independent directors preferred to remain passive; they failed to call for an investigation or scrutinise the board's finance and risk committee. Additionally, there was no call for a capital infusion despite the fact that one was required.⁸⁴ Crucially, the question of qualifications came up, raising serious concerns. The bank had ten independent directors in its board upon its collapse; half of these directors were over the age of 70, and amongst these two were in their 80s. Out of the ten directors, nine were retirees, four were aged over 75 and one was a former Admiral who had previously worked in human resources. And out of all of them only two had experience in the financial services industry. Kaufman, an 80-year-old, chaired the board's finance and risk committee and Fuld, the bank's chief executive, served as the Chairman of both the board and the executive committee, alongside an 80-year-old independent director. Interestingly in 2009 Fuld was ranked number one on 'The Worst American CEOs of All Time' list; he was also characterised by the magazine compiling the list as "belligerent and unrepentant".⁸⁵

3.2.2. A Paradigm from the Continent of Europe: Northern Rock - A Tail of Hubris, Greed and Ignorance

⁸² House of Representatives, Hearing Before the Committee on Oversight and Government Reform, 2008. *The Causes and Effects of the Lehman Brothers Bankruptcy* (One Hundred Tenth Congress, Second Session, October 6, 2008).

⁸³ Bob Tricker, *Corporate Governance – Principles, Policies and Practices* (2nd edn, Oxford University Press 2012) 156.

⁸⁴ Bob Tricker, *Corporate Governance – Principles, Policies and Practices* (2nd edn, Oxford University Press 2012) 156.

⁸⁵ Compiled by Conde Nast Portfolio: 'Portfolio's Worst American CEOs of All Time: Dick Fuld' *Portfolio.com* (New York, 30 April 2009) <http://www.aol.com/article/2009/04/24/portfolios-best-and-worst-ceos/1527066/> accessed 23 May 2016.

The collapse of Northern Rock constitutes the first UK casualty of the 2008 financial crisis; it is also a metaphor for the breakdown of corporate governance in modern times. This is yet another story of hubris and greed, and of bankers ignorantly believing that their 'clever' new financial ways can free them from the dull realities of everyday economic life. It is also a story of poor understanding and pure ignorance. Northern Rocks' problems were primarily caused by three key factors: its speedy growth powered by forceful lending to somewhat uninformed borrowers, the absence of proper supervision by the Financial Services Authority, and the tolerant environment that prevailed at the time, of lax bank safety rules and lax regulation.⁸⁶ This tolerant atmosphere was exploited by the bank, eventually finding itself with no reserves to protect itself against unforeseen losses.⁸⁷ More specifically, approximately ten years before its eventual catastrophe, the bank, whilst manipulating loosening regulation, began to borrow heavily on the wholesale financial markets in order to fund up to 125% mortgages. Of course it did so with the approval of the City of London. At that stage Northern Rock's share price increased to levels no one could have anticipated.⁸⁸ But following the decline of the US subprime mortgage market, the mortgage securitisation market also suffered a decline. As a result Northern Rock found itself unable to raise the funds needed to continue with its day-to-day operations. Desperate for help, it was granted liquidity support from the Bank of England as lender of last resort. Yet still, once the public became aware of the catastrophic events, it was too late to save the bank; there was a crisis of confidence and a complete loss of trust, resulting in the first bank run in 150 years.⁸⁹

⁸⁶ Note that in the wake of the financial crisis, the Financial Services Act of 2012 set out a new system for regulating financial services in the UK. The current regulatory model transfers the responsibilities of the former FSA to two new bodies, the 'Prudential Regulation Authority' (PRA) and the 'Financial Conduct Authority' (FCA). The FCA, which regulates banks, building societies, insurers, independent financial advisers, mutual societies and investment managers and stockbrokers, is responsible for ensuring conduct and markets regulation is stricter and more involved with consumers.

⁸⁷ According to an FSA internal audit, the bank's supervisors met Rock staff just seven times in the 18 months before the run, and failed to question its aggressive growth targets and reliance on wholesale funding. Financial Services Authority, *The Supervision of Northern Rock: A Lessons Learnt Review* (Internal Audit Division Report, 2008) <http://www.fsa.gov.uk/pubs/other/nr_report.pdf> accessed 15 April 2016. Also, see Brooke Masters, 'Northern Rock Exposed Regulatory Failings' *Financial Times* (London, 12 September 2012) 16. Also see Joanna Gray and Orkun Akseli (eds), *Financial Regulation in Crisis?* (Edward Elgar Publishing Ltd 2011) 56. Northern Rock's run was the first run an English bank since Overend Gurney in 1866.

⁸⁸ Giles Frazer, 'If the Northern Rock Fiasco was a Morality Tale, it was More About Hubris Than Greed' *The Guardian* (London, 14 September 2012) 12.

⁸⁹ Due to the severity of the situation the UK Treasury, to bring an end to the panic, agreed to protect all bank's deposits as well as all new retain deposits as well. Five months after the end of the run, Northern Rock was nationalised.

The report published on the collapse of Northern Rock (by the Treasury Committee of the UK House of Commons) concluded that a general culture of recklessness and irresponsibility dominated the bank; so much so in fact, that strong warning signals pointing to the bank's vulnerability were largely ignored. To start with, the report noted that the rate of growth of the bank itself was unhealthy and unrealistic. The steep drop in the bank's share price (especially compared to other banks) was also abnormal, normally indicative of the fact that the strategy is 'high-risk' and the funding policies, reckless and inappropriate.⁹⁰ Yet, despite the numerous warning signals, the bank's top people were 'asleep at the wheel' in the run up to the collapse. Crucially, they failed to take steps to ensure the bank remained liquid as well as solvent. They failed to insure the bank against its own risky schemes and speculations, failing also to act as a restraining force against the risky strategies taken by other executive members.⁹¹ Remarkably, they had little appreciation of the nature of their actual job: the level of supervision performed by the board of directors in monitoring the bank's financial condition was poor, and the degree of insurance and cover against the bank's risky strategies was negligible - they even opted out of organising a standby facility or cover for the risks assumed by the bank. All in all there was 'ambiguity and confusion' regarding the ownership of risks associated with off balance sheet vehicles, an ambiguity that played a crucial part in the market's instability.⁹² Eventually Northern Rock was unable to protect itself against the significant liquidity pressures it encountered following the freezing of the international capital markets in August 2007. Within this environment there was a general absence of knowledge and experience by the executives: for example prior to the bank's collapse the board made two crucial appointments to the positions of Chairman and Chief Executive despite the appointees' obvious lack of qualifications, banking training or financial expertise.⁹³

⁹⁰ House of Commons Treasury Committee, *The Run on the Rock*. (HC 56-I, Fifth Report of Session 2007-08) – Report, Together with Formal Minutes London: TSO (The Stationery Office), 16-18, 23.

⁹¹ House of Commons Treasury Committee, *The Run on the Rock*. (HC 56-I, Fifth Report of Session 2007-08) – Report, Together with Formal Minutes London: TSO (The Stationery Office), 19.

⁹² House of Commons, Treasury Committee, *Financial Stability and Transparency*. (HC 371, Sixth Report of Session 2007-08) - Report, Together with Formal Minutes London: TSO (The Stationery Office), p. 77. Also see Roman Tomasic, 'Corporate Rescue, Governance and Risk Taking in Northern Rock: Part 2' [2008] 29 Company Lawyer 330, 331.

⁹³ This is according to the report 'The Run on The Rock': House of Commons Treasury Committee, *The Run on the Rock*. (HC 56-I, Fifth Report of Session 2007-08) – Report, Together with Formal Minutes London: TSO (The Stationery Office).

4. Back to Basics: Educating Bankers on the Law, Ethics and Social Values

Markets lie at the heart of every prosperous economy but markets do not function well on their own; governments play a role in regulating markets to avert the kinds of failures experienced in 2008. The role of the market as a tool for controlling behaviour is limited. That being said, conventional methods toward law and regulation are fairly unproductive in adjusting the social costs of market failure. One way forward is increased regulation, for instance regulation restricting or inhibiting the use of over-the-counter derivatives for banks.⁹⁴ But law and regulation alone are incapable of providing whole solutions to the breakdown in management performance. They are incapable of reacting fast enough to tackle the potential harms that might derive from innovative financial ideas such collateralized debt obligations and derivative securities; certainly the many failures and scandals resulting from the 2008 financial crisis are indicative of that law adherence does not automatically result in acceptable and ethical behaviour. But here is the difficulty: things cannot just improve with a simple observance of the law.⁹⁵ Yet, when there is huge discontent of companies for their disregard of corporate social responsibility how can large businesses alter decades of practices in favour of methods that are more fitting and ethical? The question therefore is where else to turn to when both markets and law are incapable of accomplishing their social promise.⁹⁶

If regulation and restructuring were to work, the way bankers do business would need to change. Bankers would need to alter the way they understand their jobs, particularly the consequences of creating and encouraging excessive risk-taking, and of generating high debts whilst imposing excessive transaction costs. This would involve retuning their professional values to bring them more in line with their personal choices. This is a crucial step, particularly in light of studies pointing to behavioral weaknesses and ignorance of the effects of widespread methods such as

⁹⁴ Joseph Stiglitz, 'Regulation and Failure' in David Moss and John Cisternino (eds), *New Perspectives on Regulation* (The Tobin Project 2009) 15.

⁹⁵ For an interesting discussion on codes of ethics, see: Trish Keeper, 'Codes of Ethics and Corporate Governance – a Study of New Zealand Listed Companies' in P.M. Vasudev, Susan Watson (eds), *Corporate Governance After the Financial Crisis* (Edward Elgar Publishing Ltd 2012) 271. Also, see Muel Kaptein and Johan Wempe, *The Balanced Company: A Theory of Corporate Integrity* (Oxford University Press 2002).

⁹⁶ A question also addressed by: Dan Awrey, William Blair and David Kershaw, 'Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?.' (LSE Law, Society and Economy Working Papers 14/2012, 2012) <<http://www.lse.ac.uk/collections/law/wps/wps.htm>> accessed 12 March 2016.

securitization and short-termism. In this regard education is a solid measure, especially the type that highlights the positives of corporate social responsibility and sustainability. The type that teaches or reminds one (whichever one applies) of what the law *actually* says: that it is perfectly fine to be more inclusive during the decision-making process;⁹⁷ that having a long-term collective outlook is perfectly acceptable too. That section 172 of the Companies Act 2006, enacted to eradicate short-termism, *does* in fact encourage management to care about a firm's long-term sustainable growth.⁹⁸ In this regard, education is a useful tool specifically *before* one assumes a leadership position.⁹⁹ And what of the bigger picture? It is to help restructure and correct principles and ideals. Otherwise, executives will continue to seek ways around new rules, profit maximization being their main goal, and all the while acting in a way that is at best ignorant of consequences and at worst self-serving and dishonest – both being a serious threat to a firm's sustainability, and even to bankers' personal well-being.¹⁰⁰ Perhaps the key here is to seek mundane solutions than multifaceted ones; even to complex matters such as these simplicity might after all, work best.

4.1. The Splendour of Educating Bankers on Law and Other Matters: A Simple (Yet Powerful) Measure

⁹⁷ Demetra Arsalidou, 'Shareholders and Corporate Scrutiny: the Role of the UK Stewardship Code' [2012] 9(3) European Company and Financial Law Review 342.

⁹⁸ Particularly sections 172 and 417 Companies Act 2006.

<<http://www.law.leeds.ac.uk/assets/files/research/events/directors-duties/keay-the-duty-to-promote-the-success.pdf>> accessed 16 April 2016, 31.

⁹⁹ Also important is training, and a meaningful tool *after* one assumes a leadership position. Investment bankers receive a large part of their training through their employer. Currently, there are numerous training requirements. New trainees must complete the training and exams provided by the Financial Conduct Authority (FCA), a regulatory requirement for anyone working in investment banking in the UK. New trainees are normally introduced to the sector via intensive company induction programmes, which may last four to eight weeks. Training programs tend to focus on areas such as risk, markets, accounting, financial statement analysis, and financial modelling, corporate finance, economics and capital markets. Senior professionals from within the company, as well as industry experts deliver these programmes. They are designed to provide a comprehensive overview of the particular sector(s). Induction programmes bring together new trainees from across the organisation. The focus is on team building and case-study-based learning. Once inductions are completed, additional training may be provided through in-house courses and seminars and working alongside those already established in the role. Additionally, there are employers who ask for additional professional qualifications. Many are available: for instance the Chartered Institute for Securities & Investment (CISI) provides a number of qualifications related to the work of investment bankers, which are approved by the FSA. Importantly corporate investment bankers, on the successful completion of their initial certificates they can proceed with the undertaking of further professional development, for instance by reading for the global qualification called the Corporate Finance Qualification, a qualification provided by ICAEW, i.e. the Institute of Chartered Accountants in England and Wales. There are more training courses for anyone wishing to do even more, provided by the Chartered Financial Analyst Society of the UK, and The Association of Corporate Treasurers.

¹⁰⁰ A banker has little personal benefit in acting carelessly: the poor performance of functions can result in job losses, loss of credibility and damage to an individual's reputation.

Let us begin with posing a question. What do the following have in common: the collapse of Northern Rock in the UK, the catastrophic events of Fortis Bank in Belgium, and the Lehman brothers' fiasco in the US? All reflect serious problems underlying bankers' behaviour and attitudes. Cases such as Northern Rock, Fortis and Lehman Brothers might be commonplace but their commonality does not make them any the less disturbing; the opposite in fact. What *is* troubling is that they should not have gotten so bad. Executives appeared unable to appreciate their firms' strategies; they were consequently unable to manage their resultant risks. On the one hand the market conditions were hard. Yet, the banks' practices and products were so complex that even their own executives had difficulty understanding what they actually meant. They seemed incapable of appreciating that these business models were based on faulty value-at-risk and that they had the potential to drive their banks to total failure or near-collapse. In their state of ignorance executives gave way to unreasonable compensation packages which incentivised the pursuing of short-term profits; profits that were reliant on excessively risky behaviour. Through obliviousness they increased systemic risk in the financial system minimising their banks' profitability in the process.¹⁰¹ But why were directors so confused of their obligations and expectations? What were the reasons for their (often detrimental) actions? Numerous as they were, behavioural limitations and ignorance lay at the core. Take Barings for example: the directors' breach of duty involved not so much discrete failures of management but more a general failure to manage; not so much bad management as to *non*-management.¹⁰² Or in Northern Rock the executives appeared incapable of appreciating the complexities of the bank's business strategy – that it was too reckless and high risk. That put them in a weak position, making them unable to properly supervise the own bank's operations.¹⁰³ In Citigroup one executive famously declared that "as long as the music is playing, you've got to get up and dance",¹⁰⁴ and in HBOS a former chief executive looked back on his record upon his departure and said "now

¹⁰¹ House of Commons, Treasury Committee, *Banking Crisis: Regulation and Supervision* (HC 767, Fourteenth Report of Session 2008-09) – Report, Together with Formal Minutes London: TSO (The Stationery Office), evidence 57.

¹⁰² *Re Barings Plc & Others (No 5)* [1999] 1 BCLC 433, at 483.

¹⁰³ House of Commons Treasury Committee, *The Run on the Rock*. (HC 56–I, Fifth Report of Session 2007-08) – Report, Together with Formal Minutes London: TSO (The Stationery Office), 3.

¹⁰⁴ Michiyo Nakamoto and David Wighton, 'Bullish Citigroup is 'Still Dancing' to the Beat of the Buy-Out Boom' *Financial Times* (London 10 July 2007) 12.

that I know what I know, I wish I'd been bolder".¹⁰⁵ The behavioural bias of overconfidence is openly demonstrated in these cases.

Here is the difficulty: the world has come to accept that the value of what bankers do is defined by the market. If the market tolerates a certain type of behavior, if such behavior is legal, no other test of properness can be relevant. Moreover, when executives and banks think of progress they only mean financial progress, and the measure of that is today's share price; this is still the case despite the shock the financial world has experienced in 2008. But as we learn from the global financial catastrophe this is not always so. And as we also learn, many times management failures stem from a basic misconception on the directors' part of the extent of their management responsibilities. That bankers underestimated the risks involved to such a degree as to cause the biggest financial crisis since the Great Depression is partly the result of ignorance and behavioural limitations. It appears that possessing an in-depth understanding of today's complex business structures is beyond the ability of many; consequently, they would rather refrain from scrutinising and challenging decisions preferring to function as members of a cosy club instead.¹⁰⁶ But how can they ever do a good job if they do not appreciate the intricacies involved? How can they do justice to their profession if they are subject to behavioural limitations that restrict their abilities to function as expected?

After the worldwide recession at the end of the last decade, some, rightly or wrongly, assigned responsibility at business schools for failing to instill the significance of corporate social values on to their students. Financial models and financial theories were heavily criticised, but so were business schools for having had a negative influence on executives' style of management. This is particularly so with regards to the US business schools (although not exclusively).¹⁰⁷ Business schools have not been tough enough to offer graduates the ammunition needed to ensure temptations and unreasonable risks are avoided. Research conducted by the Association of MBA's

¹⁰⁵ As stated by senior banker, James Crosby: see James Croft, 'Sir James Leaves HBOS on a High Note' *Financial Times* (London, 28 July 2006) 8.

¹⁰⁶ House of Commons, Treasury Committee, *Banking Crisis, Reforming Corporate Governance and Pay in the City*. (HC 519, Ninth Report of Session 2008–09) - Report, Together with Formal Minutes London: TSO (The Stationery Office).

¹⁰⁷ Howard Davies, *The Financial Crisis: Who is to Blame?* (Polity Press 2010) 191; Demetra Arsalidou, *Rethinking Corporate Governance in Financial Institutions* (Routledge 2015).

indicates that only 20% of MBA courses incorporate a compulsory corporate social responsibility module in their syllabuses.¹⁰⁸ Unlike other subjects such as arts, philosophy and history, business schools do not help students develop skills such as critical thinking and moral reasoning.¹⁰⁹ Interestingly, according to an online poll conducted by the Harvard Business Review, two out of three respondents consider business schools partially responsible for the absence of ethical values amongst graduates.¹¹⁰ In fact, to many critics this is one of the reasons MBA-holders take short-sighted and self-serving decisions.¹¹¹ Short-term performance remains the priority of the majority, a type of mentality that does not exclusively originate in company boardrooms; from an early stage candidates are taught to focus on short-term returns; indeed, it is argued that business schools exaggerate the importance of short-term returns and by doing so they inadvertently disregard ethical principles.¹¹² But not only that: they also disregard the true sense of the law. These observations are important, especially in light of studies suggesting that undergraduate and graduate training, and undergraduate degrees from best-in-class institutions are linked to better company performance.¹¹³ Also, it appears that what one learns in school and university can become obsolete within years after graduation;¹¹⁴ however this is interpreted, it cannot

¹⁰⁸ Association of MBAs Publications, <<http://www.mbaworld.com/en/Evidence-and-Ideas/Publications.aspx>> accessed 21 May 2016. Also see Adam James, 'Academies of the Apocalypse?' *The Guardian* (London, 7 April 2009) 10. James explains that a US website characterized business schools the 'academies of the apocalypse', naming and shaming numerous international prestigious MBAs and some of their graduates. For instance, it named Harvard MBA graduate Henry Paulson, who was Secretary of the Treasury under President Bush and who was against government regulation of Wall Street and the then HBOS chief executive, Andy Hurnsby.

¹⁰⁹ Harvard Business Review, *The Buck Stops (and Starts) at Business Schools* (Harvard Business Review June 2009) <<https://hbr.org/2009/06/the-buck-stops-and-starts-at-business-school>>.

¹¹⁰ Harvard Business Review, *The Buck Stops (and Starts) at Business Schools* (Harvard Business Review June 2009) <<https://hbr.org/2009/06/the-buck-stops-and-starts-at-business-school>>; Also see Howard Davies, *The Financial Crisis: Who is to Blame?* (Polity Press 2010) 192.

¹¹¹ Harvard Business Review, *The Buck Stops (and Starts) at Business Schools* (Harvard Business Review June 2009) <<https://hbr.org/2009/06/the-buck-stops-and-starts-at-business-school>>.

¹¹² Howard Davies, *The Financial Crisis: Who is to Blame?* (Polity Press 2010) 175. Also, it is interesting to note that MBA candidates choosing to specialise in CSR report that they are either made fun of, or face long pauses and blank faces when announcing their specialization to others according to research conducted by Forbes magazine: 'Ah the Eco Warriors' (Forbes Magazine, 23 March 2011) <http://www.forbes.com/sites/csr/2011/03/28/does-an-mba-in-csr-devalue-your-resume/#3d1eb9d12c6d>

¹¹³ For instance see the research conducted by Carola Frydman, *How to Optimize Company Performance* <<http://www.clomedia.com/2013/04/01/how-to-optimize-company-performance>> accessed 22 May 2016. Also see Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar, 2012).

¹¹⁴ As noted by Stiglitz in an interview with the Yale School of Management: Jeffrey E Garten, Interview with Joseph Stiglitz, Nobel Laureate, University Professor Columbia University, Yale School of Management (Yale, 17 February 2014). Also, one interesting way forward is presented by Orts: Orts points to the fact that in the US, for-profit corporate executives and directors are counseled to consider ethical matters carefully, ethical matters that reasonably considered as necessary to the proper management / handling of business. They are also counseled to dedicate a reasonable amount of resources to public welfare, educational, and humanitarian aims. What the UK

be right particularly post-2008. At least implicitly a hands-off attitude to education and training encourages bankers to evade responsibility. The matter is simple therefore: we must no longer put up with crusty old degree programmes that have lost their relevance to the modern world.

Evidently education does play its role in the failure of bankers to act with ethos and social responsibility. Whatever the evidence however, this subject spawns difficulties and controversies with respect to the responses, at least in part because it is hard for people to wrap their minds around the notion of education as a solution. For many, the facts on the ground do not yet support such a simple approach. There are those caught up in the idea that measures have to be really tough and that education is not a strong tool; meanwhile, one of many hindrances to such an approach is that university degrees might pose an obstacle from any attempt to implicate them. But this is the time that universities need to 'take one for the team'. The path of renewal has to start with acknowledging that there is a powerful moral dimension to what has happened, and to learn about this moral dimension education is the most efficient tool, certainly *before* one assumes an executive role. Corporate social responsibility is about personal values of trust, ethics and accountability; it is not about having no business sense. Future leaders need to be educated to the extent that they understand that as guardians of great public interest, what they choose to do can (and does) result in severe societal implications. As a former executive of HSBC once said, "one of the most obvious and commonplace manifestations of the tendency to compartmentalize is seeing our work as being a neutral realm in which questions of value, other than shareholder value, or rightness, other than what is lawful, need not arise. Compartmentalization is employed because it helps to shut out the difficult questions that trouble our conscience."¹¹⁵ Future leaders need to appreciate that good leadership is not just about rewards – it is about a leader's responsibilities towards a firm's stakeholders. That the traditional educational system is not up to the task can

does is to insert s. 172, explain it, and to require directors 'to act fairly' as well as to maintain "a reputation for high standards of business conduct": As Orts explains, at least to a degree, these provisions are meant to help promote firms to care about hybrid social purposes in their decisions. However, it is crucial to train directors to understand what s.172 *really* says: Eric W Orts, *Business Persons – A Legal Theory of the Firm* (Oxford University Press 2013), 112.

¹¹⁵ As found in Bert van de Ven, 'Banking after the Crisis: Towards an Understanding of Banking as a Professional Practice' [2011] 18 *Ethical Perspectives*, 541.

no longer be acceptable, particularly as the complexity of the modern economy requires nonstop learning for new responsibilities and tasks.

Nonetheless, this debate is not merely about how ethos matters in banking. It is also about misconceptions – pure and simple. In the modern investment environment investors engage in short-term trading strategies rather than long-term goals and their portfolio choices are based on immediate returns.¹¹⁶ There is evidence in fact, of investors majoring on short-term benefits.¹¹⁷ Still, this does not mean that executives must act accordingly, nor does it mean that if they choose not to, they will inevitably be in breach of their duties. And precisely this is a key issue here: there is a general lack of awareness of what the law actually says. Certainly as fiduciaries directors are *already* required to act with honesty, integrity and ethos throughout their careers; this is already instilled in law. But the law also tells management to be more inclusive in their decision-making and to consider a firm's long-term sustainable growth;¹¹⁸ it tells them that they are to benefit the members whilst taking into account the relationship of the company with other stakeholders. This is under section 172 of the Companies Act 2006, intended to prevail over the focus on short-termism whilst encouraging firms to have a greater long-term outlook and to care more about hybrid social purposes.¹¹⁹ The overreaching duty of directors is to promote the success of the company for the benefit of its members as a whole and in doing so, they should take into account (amongst other matters) the likely consequences of any decision in the long term.¹²⁰

¹¹⁶ Andrea S Ginevri, 'The Rise of the Long-Term Minority Shareholders' Rights in Publicly Held Corporations and its Effect on Corporate Governance' [2011] 12 European Business Organisation Law Review 587, 591; Alessio M Paces, 'Consequences of Uncertainty for Regulation: Law and Economics of the Financial Crisis' [2010] 4 European Company and Financial Law Review, 479, 504.

¹¹⁷ Andrew Keay, 'The Global Financial Crisis: Risk, Shareholder Pressure and Short-Termism in Financial Institutions' (Working Paper Centre for Business Law and Practice, School of Law, University of Leeds, August 2010) < <http://www.law.leeds.ac.uk/assets/files/research/events/directors-duties/keay-the-duty-to-promote-the-success.pdf> > accessed 16 April 2016, 13. Keay explains some of the reasons shareholders put pressure for short-term gains. For instance, it can be difficult for them to measure the performance of a company when a long-term approach is implemented. Also see the UK's Department of Business, Innovation and Skills survey: Department of Business, Innovation and Skills, 'A Long-Term Focus for Corporate Britain – A Call for Evidence' (2011) <<http://www.bis.gov.uk/assets/biscore/business-law/docs/10-1225-long-term-focus-corporate-britain>> accessed 09 May 2016.

¹¹⁸ Demetra Arsalidou, 'Shareholders and Corporate Scrutiny: the Role of the UK Stewardship Code' [2012] 9(3) European Company and Financial Law Review 342.

¹¹⁹ Eric W Orts, *Business Persons – A Legal Theory of the Firm* (Oxford University Press 2013) 218.

¹²⁰ Part 10, Section 172 of the Companies Act 2006. They should also have regard to the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and others, the impact of the company's operations on the community and the environment, the desirability of the company maintaining a reputation for high standards of business conduct, and the need to act fairly as between members of the company.

Directors are not merely morally inclined to adhere to s.172 – its approach endorses the long-established principle in *Greenhalgh v Arderne Cinemas Ltd*¹²¹ that a company is not distinct from its shareholders; rather, the ‘best interests of the company’ are equated with the collective interests of the shareholders. Future bankers must be educated to the full effect of the law: that the consideration of interests other than those of shareholders is not a mere idealistic or impractical notion from which nothing concrete can emerge. Increased shareholder value should be one of the by-products and not the top priority of directors. Although the language of section 172 is ripe for interpretation, ‘the devil is in the detail’. Despite pressures faced, focusing on the long-term than the short-term stock price performance is perfectly legitimate, particularly post-2008.¹²² Crucially, once the fixation with increasing shareholder value is substituted with the true goal behind section 172, the short-term rewards, used to incentivize managers to manage short-term expectations, will gradually fade. This is an attractive and innovative approach that must be celebrated, not overlooked; it is an approach that can actually increase the overall competitiveness, wealth and welfare for all.¹²³

Furthermore, future executives must learn about the numerous behavioural limitations that can potentially constrain their ability to do a good job: overconfidence and over-optimism being key traits. Studies also point to heuristics, defined as mental shortcuts used to simplify or even oversimplify decisions taken under uncertainty.¹²⁴ It is vital they learn that decisions can often depart from the image of rational utility maximizers

¹²¹ *Greenhalgh v Arderne Cinemas Ltd (No 2)* 1 [1946] All ER 512; [1951] Ch 286

¹²² David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities – Final Recommendations* (London 26 November 2009)

<http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf> accessed 12 May 2016, 75.

¹²³ Department of Trade and Industry Consultative Company Law Reform, *Company Law Reform*. (London, Pub Ref: CM 6456, 2005).

¹²⁴ Daniel Kahneman and Amos Tversky, ‘Prospect Theory: an Analysis of Decision under Risk’ [1979] 47 *Econometrica*, 263; Amos Tversky and Daniel Kahneman, ‘On the Psychology of Prediction’ [1973] 80 *Psychological Review* 237. Also, see Emiliios Avgouleas, ‘The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform’ [2009] 6(4) *European Company and Financial Law Review* 440; Demetra Arsalidou, ‘Institutional Investors, Behavioural Economics and the Concept of Stewardship’ [2012] 6(6) *Law and Financial Markets Review* 410; Guido Kordel, ‘Behavioral Corporate Governance From a Regulatory Perspective: Potentials and Limits of Regulatory Intervention to Impact the Conduct of Corporate Actors’ [2008] 9 *European Business Organisation Law Review* 29, 62; Donald C Langevoort, ‘Behavioral Approaches to Corporate Law’ in Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar 2012) 16; Emiliios Avgouleas, ‘The Global Financial Crisis, Behavioural Finance and Financial Regulation: in Search of a new Orthodoxy’ [2009] *Journal of Corporate Law Studies* 9, 23-59.

that neoclassical economics has designed for market participants. Business education must not turn a blind eye to the boundaries of human rationality; boundaries that can lead to the bubbles and bursts witnessed in the past few years. By learning about the behavioural flaws that are potentially awaiting them, executives can be better prepared to function in the world of finance. This will help them obtain a better understanding of strategies, monitor management better, improve on their skills and have more restraint in their actions. This is particularly important as post-crisis research signifies the poor judgment and unfamiliarity shown by executives regarding their business's financial nuances and related risks.¹²⁵

Education is also a cost-efficient way to reduce the so-called 'agency costs'; these are costs that arise each time a director pursues his or her own agenda at the expense of the company. The greater the complexity of the functions assumed by the agent and the greater the discretion vested in the agent, the higher these agency costs are likely to be.¹²⁶ In a public lecture Hoffmann L.J. stressed the need to ensure such costs are controlled in the most efficient way, as the success of the management of the company, depends upon, among other things, the control of such costs.¹²⁷ Since agency costs are factored into the price that investors are willing to pay for shares, firms are keen to reduce such costs in order to increase the price eventually paid by investors.¹²⁸ Paradoxically, the reduction of such costs can actually benefit the agents as much as the principals; this is because the principal will be willing to offer greater compensation to an agent if the principal is convinced that the agent is trustworthy and honest.¹²⁹ Therefore, directors must learn that there are huge benefits in reducing agency costs; essentially any reduction, no matter how small, can help diminish the divergence of interests typically present between firms and managers.

¹²⁵ Emiliós Avgouleas, *Governance of Global Financial Markets – the Law, the Economics, the Politics* (Cambridge University Press 2012) 121. For an excellent review of these biases, see Thomas Gilovich, Dale Griffin and Daniel Kahneman, *Heuristics and Biases: The Psychology of Intuitive Judgment* (Cambridge University Press 2002). Also, see S Trevis Certo, Brian L Connelly and Laszlo Tihanyi, 'Managers and Their not-so Rational Decisions' [2008] 51 *Business Horizons* 113. This is unlike the approach followed by many economists, referred to as 'neo-classical purists'.

¹²⁶ John Armour et al., *The Anatomy of Corporate Law* (OUP 2009) 35.

¹²⁷ The Rt Hon. Lord Hoffmann, 'The Fourth Annual Leonard Sainer Lecture: The Rt Hon Lord Hoffmann' [1997] 18 *Company Lawyer* 194.

¹²⁸ Eilis Ferran, *Company Law and Corporate Finance* (OUP 1999) 118; Demetra Arsalidou, 'The Regulation of Executive Pay and Economic Theory' [2011] 5 *Journal of Business Law* 431, 437.

¹²⁹ John Armour et al., *The Anatomy of Corporate Law* (OUP 2009) 36. Also see Demetra Arsalidou, 'The Regulation of Executive Pay and Economic Theory' [2011] 5 *Journal of Business Law* 431, 437.

On a positive note, there is anecdotal evidence that the role of corporate social responsibility on MBA programs is growing. In our 'post-global crisis era' this is certainly encouraging. Themes and ideas that were on the fringes have now entered the education arena and with any luck will not disappear if and when opposition rallies against them. This is happening at Harvard and elsewhere, where task forces have been established to ascertain problems and suggest ways to improve matters in business schools. For instance, a post-crisis task force has been established by London's Cass Business School¹³⁰ to evaluate the content of all its courses, both at the undergraduate and postgraduate level.¹³¹ There are further promising developments: for example the accreditation projects manager of the Association of MBA degrees (AMBA) has emphasised the need to change the way MBAs are taught in business schools.¹³² He also said that that accredited MBA programs must adopt social and ethical issues in their syllabuses, although he fell short of specifying how this can be achieved. Or the deputy director of the International Centre for Corporate Social Responsibility at Nottingham Business School emphasising the growing demand for specialist Corporate Social Responsibilities MBAs, also suggesting this is attributable to the rising significance of ethical issues at board and executive level.¹³³ Interestingly all of the Centre's seven core MBA courses are ethics-based; they focus on the theoretical and practical framework of corporate social responsibility, and the different ways of conducting a business – such as increased sustainable growth, social capital and sustainable energy production. At Haas School of Business at the University of California, Berkeley MBA students run their own 'socially responsive' investment fund. Even the QS Global has developed a ranking in 2016 for business schools that 'properly' address ethics and CSR in their curriculum.¹³⁴ Lancaster University Management School went a little further, turning a corporate social

¹³⁰ The task force is called 'The Business Ethics Teaching and Learning Task Force'.

¹³¹ Nick Paton, 'Business Schools Put Ethics High on MBA Agenda' *The Guardian* (London, 23 January 2010) 4.

¹³² Association of MBAs Publications, <<http://www.mbaworld.com/en/Evidence-and-Ideas/Publications.aspx>> accessed 21 May 2016; Nick Paton, 'Business Schools Put Ethics High on MBA Agenda' *The Guardian* (London, 23 January 2010) 4. Paton notes that before the crisis happened ethics were not at the top of the agenda of MBA degrees.

¹³³ The Nottingham Business School is one of the first UK Universities to offer such a qualification. <<http://www.nottingham.ac.uk/business/ICCSR/>> accessed 18 June 2016.

¹³⁴ Haas School of Business at the University of California, Berkeley <<http://www.haas.berkeley.edu>> accessed 19 June 2016.

responsibility elective module into a compulsory module and renaming it 'global society and responsible management'.¹³⁵ Interesting too is George Soros' donation of \$50 million to support an 'Institute of New Economic Thinking', established to promote an overhaul of economic teaching and research.¹³⁶ Moreover, business schools all over the UK, such as Amba and Durham Business School, are actively collecting data on the question of corporate social ethics; in fact, according to the Durham survey, eight out of 10 of the 500 graduates questioned believe that ethics are more weighty post-crisis.¹³⁷ The studies also point to the growing recognition that ethics and corporate social responsibility necessitate a more prominent position within MBA degrees.¹³⁸

Let us be clear here: no one is suggesting that business schools are to blame for the economic crises or the deficiencies in executive behaviour. The individuals alone are responsible, not the schools that train them.¹³⁹ In the spirit of fighting back banks are constantly running campaigns to convince the public that they are not as materialistic or evil as portrayed by the media.¹⁴⁰ Still, business education must not suffer from apathy. It must motivate reflection upon the implications of one's actions. By changing the direction of business education we can teach future leaders a thing or two: that it is not only the most lucrative decisions that matter but also the ones that bring long-term success; that the commitment to pursue broader social goals is not merely a 'hippy' and meaningless idea: it is in fact perfectly lawful and very significant. That management is there to represent the interests of the whole group; otherwise the ideology of section 172 is simply ignored.¹⁴¹ Statistics amply demonstrate the potency of the idea that future directors need better training and education; indeed, restoring

¹³⁵ Lancaster University Management School, Lancaster University <http://www.lancaster.ac.uk/lums/> accessed 19 June 2016.

¹³⁶ This Institute was launched at a conference in Cambridge in 2010.

¹³⁷ Association of MBAs < <http://www.mbaworld.com/en/Accreditation.aspx> > accessed 16 June 2016; Durham University Business School, Durham University < <https://www.dur.ac.uk/business> > accessed 18 June 2016; Nick Paton, 'Business Schools Put Ethics High on MBA Agenda' *The Guardian* (London, 23 January 2010) 4.

¹³⁸ For an excellent overview and analysis see Bert van de Ven, 'Banking after the Crisis: Towards an Understanding of Banking as a Professional Practice' [2011] 18 *Ethical Perspectives*, 541.

¹³⁹ Howard Davies, *The Financial Crisis: Who is to Blame?* (Polity Press 2010) 193.

¹⁴⁰ Bert van de Ven, 'Banking after the Crisis: Towards an Understanding of Banking as a Professional Practice' [2011] 18 *Ethical Perspectives*, 541. As Ven notes, that is why some banks are trying to change their culture, adopting stricter lines in areas such as healthier work-life balance and sexual harassment of female staff.

¹⁴¹ Directors are told by section 172 of the Companies Act 2006 that they need to think about each of their stakeholder groups, including shareholders, employees, customers, suppliers, communities and governments. Even though the relative significance of each stakeholder might differ from time to time (especially as things change within firms) each is recognised as deserving to be treated fairly, according to the circumstances.

faith through education can bring financial benefits to a large firm, for example an increase in share price could result. A rising generation of new thinkers across the globe will profit from this crucial, yet simple breakthrough.

5. Conclusions

It would be a mistake to suppose that the 2008 crisis was solely caused by the problematic investment decisions of large firms in purchasing mortgage-backed securities. It would also be a mistake to say it was caused by the poor decisions or the corruption involved in issuing these mortgages; after all, a “certain degree of corruption, manipulation and opportunism is built in to financial capitalism”.¹⁴² We have been spending too much time looking at the reasons the crisis happened and despite the apparent progress, puzzling questions remain; for instance, how were bankers even allowed to practice the method of securitisation? Certainly the behaviour of bankers has become the one challenge to the political legitimacy of the market economy itself.¹⁴³ The banking world needs a radical change if it is to become more effective and more accountable.

It is said that a near-death experience pushes one to reconsider ideals and significances. The near-death experience of the global economy revealed not only weaknesses in the prevailing economic model but also weaknesses in our society.¹⁴⁴ Given what the economy has been through, there is still a significant difference between the rhetoric of corporate governance and the reality. The rhetoric states that any corporate governance improvements are by their nature, expensive and complicated. But straightforward approaches are there for all to see. Start with education. In our private lives education and ethics play a vital role. So why is the absence of ethical education acceptable in business? Essentially the design of the education system bears a lot of the blame – it is not up to the task. Yet, some might argue that education cannot have a great effect on management performance given the complexities of the financial world. That argument misses the point. Education is

¹⁴² Duncan K Foley, ‘The Anatomy of Financial and Economic Crisis’ in Martin Wolfson and Gerald Epstein (eds) *The Handbook of the Political Economy of Financial Crises* (Oxford University Press 2013) 200.

¹⁴³ Kevin Dowd, ‘Moral Hazard and the Financial Crisis’ [1980] 29 *Cato Journal* 141,152.

¹⁴⁴ Joseph Stiglitz, *Freefall – America, Free Markets and the Sinking of the World Economy* (Tantor Media 2010).

not a mere exercise in futility and here is why: effective risk-takers, whether in business or elsewhere, are widely admired but not those who assume excessive and ill-advised risks. Education is needed to push management to price risk efficiently so as to cover both the private costs that such risk-taking poses to bank shareholders *and* the social costs for the broader economy in the event of a bank failure.¹⁴⁵ Educational progress must lean towards a moral centre that cares about both economic *and* social responsibilities. Executives must be educated on what they can and cannot do by law: they must learn that there is no true conflict of interest between the case for a social approach and the law. They must also learn about their behavioural limitations and their effect on current and future performance. They must also realise that banks can suffer massive losses due to poor judgment and unfamiliarity of financial nuances and related risks.¹⁴⁶ Ultimately, there is strong case for committing to education. And for this to work it must be rigorous, challenging and comprehensive. Society has suffered in the past from the absence of such a perspective.

It is wrong for materialism to overshadow moral obligation, and for profit to be almost exclusively short-term. Societies have always understood the human spirit is not satisfied by material progress alone; it seems that somehow this has been overlooked by the educational system. This is the epoch to change attitudes. Business schools must teach that ethics and morals are indispensable ingredients of leadership; while this cannot guarantee results, the real threat to financial stability – the human factor – can be somewhat confronted and controlled. It is possible that with the crisis' aftermath still going strong we are finally ready to change our tone. Yes, there will always be areas of disappointment – but if we attempt the simple tasks first, we might just find we are heading in the right direction. If we cannot tackle these issues persuasively now, then the ambiguity will remain, and that will signal more trouble.

¹⁴⁵ House of Commons, Treasury Committee, *Banking Crisis: Regulation and Supervision* (HC 767, Fourteenth Report of Session 2008-09) – Report, Together with Formal Minutes London: TSO (The Stationery Office), evidence 54, K. Alexander.

¹⁴⁶ Demetra Arsalidou, 'The Banking Crisis: Rethinking and Refining the Accountability of Bank Directors' [2010] 4 *Journal of Business Law* 284.